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REDEMPTIONS INCIDENT TO DIVORCE: RECONCILING SECTION 1041 AND GENERAL TAX PRINCIPLES

Leandra Lederman Gassenheimer*

INTRODUCTION

WHEN spouses who co-own a corporation divorce, they often face the question of how to divide the stock of the corporation. The United States Tax Court recently focused on the treatment of divorcing spouses divvying up shares in such corporations, deciding three cases concerning whether a corporate redemption constituted a nontaxable transfer incident to divorce within the meaning of section 1041 of the Internal Revenue Code of 1986 (Code),¹ as amended.² The full Tax Court reviewed two of these opinions.³ Interestingly, another recent case discussing the issue, decided by the Ninth Circuit Court of Appeals, involved the wife of the taxpayer whose liability was determined in one of the court-reviewed Tax Court opinions.⁴

The general facts of all four cases are as follows: Husband and wife organize a corporation. Years later, when husband and wife are still the sole shareholders of the corporation, they divorce. Pursuant to the divorce, the corporation redeems wife's shares. Husband may or may not have had a primary and unconditional obligation to purchase the shares, for which the redemption was substituted. The questions raised by these generic facts are: (1) Is wife taxed?; and (2) Is husband taxed?

Two of the cases mentioned above addressed the taxability of the redeeming spouse (wife),⁵ and two of them focused on the taxability of the nonredeeming

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1. 26 U.S.C. § 1041 (1988). Section 1041 provides, "No gain or loss shall be recognized on a transfer of property from an individual to . . . a spouse, or . . . a former spouse, but only if the transfer is incident to the divorce." *Id.*

2. See *Arnes v. Commissioner*, 102 T.C. 522 (1994); *Blatt v. Commissioner*, 102 T.C. 77 (1994); *Hayes v. Commissioner*, 101 T.C. 593 (1993).

3. *Arnes v. Commissioner*, 102 T.C. 522 (1994); *Blatt v. Commissioner*, 102 T.C. 77 (1994).

4. *Arnes v. United States*, 91-1 USTC ¶ 50,207 (W.D. Wash. 1991), *aff'd*, 981 F.2d 456 (9th Cir. 1992).

5. See *Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992); *Blatt v. Commissioner*, 102 T.C.

spouse (husband).⁶ Two of the cases also considered a temporary regulation under section 1041 (the regulation),⁷ which provides that section 1041 governs transfers to third parties in limited circumstances.⁸ The Tax Court has made little attempt to reconcile all four cases, perhaps because the cases do not all address the same side of the transaction. However, the cases need to be reconciled because of the likelihood of inconsistent results if they are not.⁹

In order to square the four cases with each other and the regulation, it is necessary to consider the tax results if section 1041 did not apply, and whether section 1041 should and does change those results.¹⁰ Part I of this article considers the tax consequences of stock redemptions where the two sole shareholders are not husband and wife. Part II analyzes section 1041 and the proper application of the regulation in light of the policies behind section 1041. Part III analyzes stock redemptions where the two sole shareholders are husband

77 (1994).

6. See *Arnes v. Commissioner*, 102 T.C. 522 (1994); *Hayes v. Commissioner*, 101 T.C. 593 (1993).

7. Temp. Treas. Reg. 1.1041-1T (1992). The regulation provides:

Q-9. May transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041?

A-9. Yes. There are three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party. Such consent or ratification must state that the parties intend the transfer to be treated as a transfer to the nontransferring spouse (or former spouse) subject to the rules of section 1041 and must be received by the transferor prior to the date of filing of the transferor's first return of tax for the taxable year in which the transfer was made. In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the non-transferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transaction that qualifies for nonrecognition of gain under section 1041.

Id.

8. *Id.* See *Arnes v. United States*, 981 F.2d at 458; *Blatt*, 102 T.C. at 80.

9. The government was whipsawed with respect to a transaction considered in two of the recent cases. See *Arnes v. United States*, 981 F.2d at 456 (stating that wife is not taxable on transaction); *Arnes v. Commissioner*, 102 T.C. at 522 (stating that husband is not taxable on transaction). That the government was whipsawed is fundamentally inconsistent with the policies behind section 1041. See H.R. REP. NO. 432, pt. 2, 98th Cong., 2d Sess. 1491-92 (1984).

10. Section 1041, which was generally effective on July 18, 1984, DEFRA § 421(d), 98 Stat. 795, changed prior law to provide a broad nonrecognition rule for transfers of property between spouses and between former spouses incident to their divorce. *Blatt*, 102 T.C. at 79.

and wife and the redemption is incident to divorce. Part III considers whether the regulation should apply to such situations, and demonstrates why it should not. Part IV discusses where the four recent cases went wrong. Part IV demonstrates that the courts did not consider both sides of the transaction as an integrated whole when characterizing certain stock transfers "deemed" to occur under the regulation. Part V concludes that because the regulation should not be applied to divorce scenarios, congressional or Treasury Department action is needed to arrive at the correct tax results in these situations.

I. NON-SPOUSAL REDEMPTION SCENARIOS

Analyzing two situations will lay a foundation to consider section 1041. In Situation One, otherwise unrelated parties, *A* and *B*, co-own a corporation. They agree to have the corporation redeem *B*'s shares. General principles of corporate tax law provide that a remaining shareholder is not taxed on the redemption of a departing shareholder's shares.¹¹ That is, the remaining shareholder is not considered to have a taxable benefit, although his percentage interest in the corporation has increased.¹² Instead, the departing shareholder is taxed on the redemption proceeds.¹³ Thus, in Situation One, *A* is not taxed, and *B* is taxed on the redemption.¹⁴

In Situation Two, *A* and *B*, still unrelated parties who co-own a corporation, sign a binding agreement that *A* will purchase *B*'s shares, and the corporation thereafter assumes *A*'s obligation and redeems *B*'s shares. This situation illustrates a notable exception to the general rule that the remaining shareholder is not taxed as a result of the redemption of the other shareholder's interest. Where the remaining shareholder had the primary and unconditional obligation to buy the departing shareholder's shares, and shifted the obligation to the corporation, the shifting obligation causes the remaining shareholder to receive a constructive dividend.¹⁵ This result is warranted by general tax principles. Essentially, the corporation paid an obligation of one of its shareholders. In general, the resulting constructive dividend arises from poor tax planning on the remaining shareholder's part. The departing shareholder is still taxed on the redemption proceeds under section 301 and section 302. His tax is premised on the bail-out of funds from the corporation. Thus, in Situation Two, *A* is taxed on

11. See *Holsey v. Commissioner*, 258 F.2d 865, 868 (3d Cir. 1958); *Wall v. United States*, 164 F.2d 462, 465 (4th Cir. 1947); *Enoch v. Commissioner*, 57 T.C. 781, 791 (1972); *Priester v. Commissioner*, 38 T.C. 316, 328 (1962).

12. Rev. Rul. 59-286, 1959-2 C.B. 103, 104; Rev. Rul. 58-614, 1958-2 C.B. 920. See *Holsey*, 258 F.2d at 868. See also *Arnes v. Commissioner*, 102 T.C. at 538 (Beghe, J., concurring). Both the Tax Court and the Ninth Circuit applied this rule even in the context of a divorce. *Edler v. Commissioner*, 727 F.2d 857 (9th Cir. 1984), *aff'g* T.C. Memo. 1982-67. See generally *Hayes*, 101 T.C. 593.

13. I.R.C. §§ 301, 302 (1988).

14. *Id.* Cf. Rev. Rul. 69-608, 1969-2 C.B. 48, 49 Situation 5.

15. See *Schroeder v. Commissioner*, 831 F.2d 856, 859 (9th Cir. 1987); *Wall*, 164 F.2d at 465. See also Rev. Rul. 69-608, 1969-2 C.B. 48.

a constructive dividend,¹⁶ and *B* is still taxed on the redemption. Note that whether *A* is taxed has no bearing on whether *B* is taxed. In Situation Two, because of *A*'s "blunder,"¹⁷ both parties bear a tax instead of just one.

II. SECTION 1041: INTERPRETING THE STATUTE AND THE TEMPORARY REGULATION

Section 1041 provides, in part: "No gain or loss shall be recognized on a transfer of property from an individual to . . . a spouse, or . . . a former spouse, but only if the transfer is incident to the divorce."¹⁸ Section 1041 was enacted in 1984 to overrule the U.S. Supreme Court's decision in *United States v. Davis*,¹⁹ which held that, except for equal divisions of community property,²⁰ a spouse transferring appreciated property incident to divorce must recognize gain for tax purposes.²¹ Under *Davis*, the transferee spouse's basis in the property was the fair market value of the property at the time of transfer.²² The application of state law and the community property exception caused confusion,²³ and the fair market value basis rule caused the government to be whipsawed when the transferor did not report gain on the transfer.²⁴ Congress enacted section 1041 partly to prevent the government from being whipsawed.²⁵

In contrast to the *Davis* rule, the "basic policy" of section 1041 is to treat husband and wife, divorcing or not, as a single economic unit.²⁶ Of course, section 1041 does not eliminate entirely taxation on appreciation in the transferred property. Taxation is merely deferred until the property is transferred outside the spousal unit. In effect, this allows the spouses to determine who will bear the tax consequences associated with an eventual sale of a piece of property.²⁷

16. Rev. Rul. 69-608, 1969-2 C.B. 43, 43.

17. See *Arnes v. Commissioner*, 102 T.C. at 538 (Beghe, J., concurring).

18. 26 U.S.C. § 1041 (1988).

19. 370 U.S. 65 (1962). See H.R. REP. NO. 432, pt. 2, 98th Cong., 2d Sess. 1491 (1984).

20. See Michael Asimow, *The Assault on Tax-Free Divorce: Carryover Basis and Assignment of Income*, 44 TAX L. REV. 65, 66-67 (1988); C. Garrison Lepow, *Tax Policy for Lovers and Cynics: How Divorce Settlement Became the Last Tax Shelter in America*, 62 NOTRE DAME L. REV. 32, 37 (1986).

21. *Davis*, 370 U.S. at 71. See Asimow, *supra* note 20, at 66.

22. *Davis*, 370 U.S. at 72-73.

23. See, e.g., Alan L. Feld, *Divorce and Redemption*, 64 TAX NOTES 651, 652 (1994) (referring to the post-*Davis*, pre-1041 period as an "era of litigation and planning uncertainty"); Lepow, *supra* note 20, at 37 n.33 ("The tax results under the *Davis* principle became erratic when the federal and state laws did not mix well."); C. Garrison Lepow, *Reforming the Tax Treatment of Divorce: Splitting the Benefits of a Split*, 7 U. PUGET SOUND L. REV. 441, 455 (1984) ("Property settlement is further complicated under current law because of substantive problems relating to state law presented by the *Davis* case.").

24. Asimow, *supra* note 20, at 68.

25. H.R. REP. NO. 432, pt. 2, 98th Cong., 2d Sess. 1491-92 (1984).

26. *Blatt v. Commissioner*, 102 T.C. 77, 80 (1994). See H.R. REP. NO. 432, pt. 2, 98th Cong., 2d Sess. 1491 (1984).

27. See Michèle Leclerc & Annette Nellen, *Dividing the Closely-Held Corporation Upon*

Accordingly, section 1041 does not explicitly refer to transfers to third parties such as corporations.²⁸ Even a sale of property by a wholly owned corporation of one spouse to the other spouse generally is not treated as a transfer between spouses.²⁹ However, in contrast to the statute, the regulation resolves whether "transfers of property to third parties on behalf of a spouse (or former spouse) qualify under section 1041."³⁰ Specifically, the regulation notes:

[There are] three situations in which a transfer of property to a third party on behalf of a spouse (or former spouse) will qualify under section 1041, provided all other requirements of the section are satisfied. The first situation is where the transfer to the third party is required by a divorce or separation instrument. The second situation is where the transfer to the third party is pursuant to the written request of the other spouse (or former spouse). The third situation is where the transferor receives from the other spouse (or former spouse) a written consent or ratification of the transfer to the third party.³¹

The regulation appears to address scenarios such as where the husband owes a debt to a bank or another third party, and, pursuant to the divorce, the wife uses appreciated property to repay the bank debt, instead of transferring property to him that he will use to repay the debt.³² In this scenario, the wife's transfer of property to the bank is "on behalf of" the husband. After all, it is his debt she is repaying. By allowing this transaction to be governed by section 1041, the regulation allows a limited triumph of substance over form. That is, the transaction's form is not a transfer between spouses, but the substance is the same as a transfer from the wife to the husband and from him to the bank. Moreover, the tax consequences of this transaction under the regulation are consistent with the letter and policy of section 1041 because the transaction is the equivalent of a transfer by the wife of appreciated property to the husband (a transaction protected by section 1041) followed by a transfer by the husband to the bank.

Marital Dissolution: Three's a Crowd, CAL. TAX LAW, Summer 1994, at 19. See also Tech. Adv. Mem. 9046004 (Nov. 16, 1990) ("Under section 1041, Congress gave taxpayers a mechanism for determining which of the two spouses will pay the tax upon the ultimate disposition of the asset.").

28. See 26 U.S.C. § 1041 (1988).

29. Temp. Treas. Reg. 1.1041-1T (1992).

30. *Id.* (emphasis added).

31. *Id.* (emphasis added).

32. If the wife transferred cash to the bank to pay the husband's debt, section 1041 probably would not apply, even if the parties characterized the transfer as non-alimony; section 1041 is a gain or loss nonrecognition provision. 28 U.S.C. § 1041(a) (1988). See Richard C.E. Beck, *The Deductibility of a Worthless Right to Contribution for Joint Income Taxes: The Mistaken Line of Cases Under Rude v. Commissioner*, 9 VA. TAX REV. 313, 349-50 n.204 (1989) (declaring that, although many commentators have stated that cash is "property" for § 1041 purposes, there is no reason to treat cash as property because, among other things, there is no possibility of taxing the transferor of cash). The regulations are not very helpful on this question: "Only transfers of property (whether real or personal, tangible or intangible) are governed by section 1041. Transfers of services are not subject to the rules of section 1041." Temp. Treas. Reg. 1.1041-1T (1992).

Moreover, as discussed below, in the bank debt context, the regulation does not eliminate a tax that otherwise would apply.

The remainder of the regulation supports the bank debt conception of the regulation. It states:

In the three situations described above, the transfer of property will be treated as made directly to the nontransferring spouse (or former spouse) and the nontransferring spouse will be treated as immediately transferring the property to the third party. The deemed transfer from the nontransferring spouse (or former spouse) to the third party is not a transfer that qualifies for nonrecognition of gain under section 1041.³³

This language treats the transfer to the bank, which was made "on behalf of" the husband, as a deemed transfer to the husband, protecting the wife from taxation pursuant to section 1041. The wife would be treated as transferring the property to the husband (a transfer protected by section 1041), but the husband would be treated as transferring the appreciated property to the third party, which "is not a transfer that qualifies for nonrecognition of gain under section 1041."³⁴ Thus, the government will still collect a tax on the appreciation. The tax consequences under the regulation of the bank hypothetical are consistent with the policy of section 1041.

The three situations in which a transfer "on behalf of" a spouse is protected by section 1041 are very logical when considered in the bank debt context. The transfer to the bank could be required by the divorce or separation agreement. Or, pursuant to the second situation, the transfer on behalf of the husband to the third party bank could be pursuant to the husband's written request. Similarly, if the husband ratified the wife's transfer after the fact, it would be evident that the wife's transfer was on behalf of the husband.

The bank debt hypothetical illustrates the logic of applying the regulation to a situation where one spouse has an *obligation* to a third party that the other spouse fulfills pursuant to the divorce.³⁵ Interestingly, a temporary alimony regulation promulgated the same day as the regulation contains language very similar to the regulation and speaks in terms of "liabilities of the payee spouse," reinforcing the "obligation" conception of the phrase "on behalf of":

May payments of cash to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are pursuant to the terms of a divorce or separation instrument? Yes. . . . For example, cash payments of rent, mortgage, tax, or tuition *liabilities* of the payee spouse made under the terms of the divorce or separation instrument will qualify as alimony or separate maintenance payments.³⁶

33. Prop. Treas. Reg., 49 Fed. Reg. 34,452-34,453 (1984).

34. *Id.*

35. See Blatt, 102 T.C. at 81-82.

36. Prop. Temp. Treas. Reg. 1.71-1T(a), 49 Fed. Reg. 34,455 (1984) (emphasis added). The

The regulation should also apply where one spouse acts as the *agent* of the other in carrying out a transaction with a third party.³⁷ For example, assume that, pursuant to the divorce, the husband retains the marital home. Assume further that the divorce decree therefore requires the husband to purchase a home for the wife. If the husband purchases a house from a third party in the wife's name, and in which she will reside, his transfer of money or other property to the third party house owner should be a transfer "on behalf of" the wife. In effect, pursuant to the divorce decree, the husband is acting as the wife's agent. The husband could have transferred the appreciated property to the wife and had her pay for the house. If instead the husband transfers appreciated property in exchange for the house, under the regulation, she will bear the tax on the appreciated property's disposition, just as if he had transferred it to her and she had used it to pay for the house.

Thus, where, pursuant to the divorce, one spouse acts as the agent of the other spouse, or fulfills an obligation of the other spouse, the resulting transactions fit squarely within the regulation as transactions "on behalf of" a spouse. In contrast, the facts of the redemption scenarios fit awkwardly at best into the language of the regulation. First, when the wife transfers her shares to the corporation in exchange for cash, in order for that redemption of her shares to be protected by section 1041, her transfer must be "on behalf of" her husband. At least in the bank debt context, it is obvious that "on behalf of" is used in its ordinary sense to mean "as agent for" or "in the stead of."³⁸ For example, if the divorce decree provided that the wife would pay the husband's reasonable attorney's fees, a transfer of property to the attorney by the wife would presumably be a transfer "on behalf of" the husband, and it would be governed by the regulation. In the redemption context, for the regulation to apply, it must be used in another sense. The wife is not acting in the stead of the husband by transferring her shares to the corporation.

If "on behalf of" were instead interpreted to mean "benefitting,"³⁹ then many transfers by the wife could be treated as being "on behalf of" the husband even though they clearly are not. For example, if, pursuant to the divorce decree, the wife paid her own attorney's fees, her payment arguably could be deemed some "benefit" to the husband (who does not have to pay the fees). If she paid the fees with appreciated property, he would be taxed. Surely, the regulation does not stretch this far. According to this analysis, nearly every property transfer pursuant to a divorce could be deemed "on behalf of" the nontransferring spouse.⁴⁰

temporary alimony regulation further provides that cash payments to a third party on behalf of a spouse qualify as alimony or separate maintenance payments if the payments are made at the payee spouse's written request. *Id.* This language also echoes the language of the regulation.

37. *Blatt*, 102 T.C. at 81.

38. *Cf. id.* (stating that a "transfer that satisfies an obligation or a liability of someone is a transfer on behalf of that person").

39. See *Arnes v. United States*, 91-1 USTC ¶ 50,207 (W.D. Wash. 1991), *aff'd*, 981 F.2d 456 (9th Cir. 1992).

40. *Cf. Arnes v. Commissioner*, 102 T.C. 522, 535-37 (1994) (Beghe, J., concurring).

In addition to the fact that a redemption of the wife's shares does not seem to be a transfer "on behalf of" the husband, applying the regulation in the redemption context would require reading in deemed transfers not provided for in the regulation. That is, the regulation provides for a deemed transfer of the wife's shares to the husband and the husband's shares to the corporation, but it does not contemplate the flow of cash back to the wife. One would have to read in an exchange of cash for the shares the husband transfers the shares to the corporation, and a transfer completely absent from the regulation: the transfer of cash from the husband to the wife. Not only does this additional transfer seem inconsistent with the regulation, it also ignores that the wife, not the husband, received the cash.⁴¹

III. SPOUSAL SCENARIOS: RECONSIDERING THE REDEMPTION TRANSACTIONS IN THE LIGHT OF SECTION 1041

Now reconsider the scenarios described at the beginning of this article—this time in the spousal context—in light of section 1041. Situation Three involves divorcing spouses who agree that their wholly owned corporation will redeem the wife's shares. In Situation Three, someone must pay tax on the bail-out of funds from the corporation; section 1041 did not exempt corporate distributions from taxation.⁴² The "someone" should be the wife. After all, she received cash in exchange for her shares. In the non-spousal context, she unquestionably would bear the tax. The parties easily could have structured the transaction differently if they wanted the husband to bear the tax instead. For example, he could have purchased her shares and had the corporation redeem them. However, lower aggregate taxation results from her being the taxpayer.⁴³ Provided the divorce is final,⁴⁴ she is likely to receive sale or exchange treatment because she is terminating her entire interest in the corporation, which will result in capital gains rates as well as an offset for her basis in the shares.⁴⁵ By contrast, if he bought her shares and had the corporation redeem some of them, he probably would receive dividend treatment.⁴⁶ The couple's division of the assets presumably reflects the lower aggregate taxation so both parties should want the wife to bear the tax.

41. See Thomas Monaghan, Note, *Corporate Redemption in the Context of Marital Dissolutions: I.R.C. § 1041 and Arnes v. United States*, 68 WASH. L. REV. 923, 926 n.20 (1993) (noting that in *Arnes* "the court did not fully describe the recast transaction" and that the court's analysis failed to account for the \$450,000 received by Mrs. Arnes).

42. Cf. *Arnes v. Commissioner*, 102 T.C. at 533-34 (Beghe, J., concurring) (stating that section 1041 did not immunize dividends from taxation).

43. See *id.* at 540.

44. If the spouses are still married (and not legally separated) at the time of the redemption, section 318(a)(1)(A) will affect whether the redemption is treated as an exchange. I.R.C. § 302(c) (1988).

45. I.R.C. § 302(a), (b)(3).

46. I.R.C. § 302(b).

If the regulation does not apply to Situation Three, the tax consequences described above would result. However, if it does apply, the husband would have to pay the tax. Under the regulation, the wife would be treated as transferring the shares to her husband, and her husband would be treated as transferring the shares to the corporation in exchange for cash. Of course, compelling arguments, discussed earlier, suggest that the regulation technically should not apply to redemptions. In addition, even if the regulation were amended to apply to redemptions, taxing the transaction to the husband instead of the wife is difficult to justify, particularly since he received no cash, did not receive a constructive dividend, received no economic benefit from the redemption under *Holsey* and it is contrary to the parties' implicit or explicit agreement that the wife would bear the tax on the redemption. In addition, the aggregate tax burden would be greater, as discussed above. All of these factors militate against applying the regulation to Situation Three.

In Situation Four, divorcing spouses sign a binding agreement that the husband will purchase the wife's shares, and the corporation thereafter assumes his obligation and redeems her shares. In Situation Four, if the regulation does not apply, the husband receives a constructive dividend because the redemption relieved his primary and unconditional obligation, clearly the result of poor tax planning. As illustrated in the non-spousal context,⁴⁷ this tax is separate and independent of the tax to the redeeming party on the redemption, so the wife would be taxed as well. This tax result is less than ideal, but it is probably the technically correct answer under current law.

If the regulation applies to Situation Four, the wife is protected under section 1041 because her transfer was "on behalf of" her husband. She is treated as transferring her shares to him, and he is treated as exchanging them for cash from the corporation and transferring the cash to her. Because the husband is deemed to receive the shares and transfer cash back to her, effectively he has complied with his purchase obligation—rather than shifting it to the corporation—so he does not receive a constructive dividend. However, as a result of the deemed transfer of the shares from the husband to the corporation, he would be taxed on the redemption, presumably receiving dividend treatment. Again, this result depends on the regulation's application in the redemption context. Applying the regulation has the beneficial effect of avoiding the taxation of both spouses on one transaction and enforcing the parties' agreement that the wife would not be taxed. But, as discussed above, the regulation is technically ill-suited to apply in the redemption context.

IV. THE RECENT CASES: WHAT WENT WRONG

In *Arnes v. United States*,⁴⁸ the spouses' wholly owned corporation operated a McDonald's franchise.⁴⁹ McDonald's Corporation informed the husband that

47. See *Schroeder v. Commissioner*, 831 F.2d 856, 859 (9th Cir. 1987); *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947). See also Rev. Rul. 69-608, 1969-2 C.B. 48.

48. 981 F.2d 456 (9th Cir. 1992).

49. *Id.* at 457.

its rules precluded joint ownership of the corporation after the divorce.⁵⁰ The spouses agreed that the corporation would redeem Mrs. Arnes' shares.⁵¹ The divorce decree incorporated this agreement.⁵² Mr. Arnes guaranteed the corporation's obligation to pay Mrs. Arnes.⁵³

Mrs. Arnes paid tax on capital gain arising out of the redemption, but later sued for a refund.⁵⁴ She argued, on the authority of the regulation, that section 1041 protected her from taxation on the distribution.⁵⁵ The crux of Mrs. Arnes' argument was that her transfer of shares to the corporation, which was required by the divorce instrument, was a transfer "on behalf of" Mr. Arnes.⁵⁶ The district court agreed, finding that the transfer "benefitted" him.⁵⁷ The court of appeals affirmed, stating in part:

Generally, a transfer is considered to have been made "on behalf of" someone if it satisfied an obligation or a liability of that person. If an employer pays an employee's income tax, that payment is income to the employee. . . . If a corporation assumes a shareholder's bank note in exchange for stock, the shareholder receives a taxable constructive dividend⁵⁸

This interpretation of the phrase "on behalf of" seems correct.⁵⁹ In addition, it appears to comport with the concept that section 1041 defers tax but does not eliminate it. The regulation merely allows one spouse to pay the debt of the other directly to the third party. If the court of appeals had actually applied the interpretation of "on behalf of" quoted above, it probably would not have affirmed the district court's decision. Mrs. Arnes' transfer of shares to the corporation was not "on behalf of" Mr. Arnes in the *Old Colony* sense.⁶⁰ It did not satisfy any obligation or liability of his. McDonald's Corporation's requirement that only one of the spouses own the franchise after the divorce did not, in tax terms, create an obligation or liability of Mr. Arnes. That is, an agreement between the spouses, whether or not required by McDonald's Corporation, that only one spouse will retain ownership after the divorce, does not obligate the husband to purchase the other spouse's shares any more than it does

50. *Id.*

51. *Id.*

52. *Id.*

53. *Arnes v. Commissioner*, 102 T.C. 522, 525 (1994).

54. *Arnes v. United States*, 981 F.2d at 457.

55. *Id.* at 458.

56. *Id.*

57. *Arnes v. United States*, 91-1 USTC ¶ 50,207 (W.D. Wash. 1991), *aff'd*, 981 F.2d 456 (9th Cir. 1992).

58. *Arnes v. United States*, 981 F.2d at 459 (citing *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729-31 (1929); *Schroeder v. Commissioner*, 831 F.2d 856, 859 (9th Cir. 1987), respectively).

59. See *Blatt v. Commissioner*, 102 T.C. 77, 84 (1994) (Halpern, J., concurring) (referring to the paragraph quoted in the text above as "a common tax meaning for the term 'on behalf of'").

60. See *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729-31 (1929).

the wife. Until one spouse signs an unconditional agreement to purchase the other's shares, no obligation exists to do so.⁶¹

As explained by the Tax Court in *Blatt v. Commissioner*,⁶² *Arnes v. United States*⁶³ seems to present an unfortunate misapplication of the regulation. In a court-reviewed opinion, the Tax Court held that a transfer by Mrs. Blatt of all of her shares to the spouses' wholly owned corporation was not a transfer "on behalf of" Mr. Blatt within the meaning of the regulation.⁶⁴ The court reasoned that the regulation did not encompass the Blatts' situation. Rather, the regulation applied to the bank debt type of situation.⁶⁵ In addition, the record did not show that the redemption satisfied any obligation of Mr. Blatt or that Mrs. Blatt was acting as Mr. Blatt's representative in the redemption—either of which would have satisfied the "on behalf of" requirement, according to the court.⁶⁶ It appears that the corporation, not Mr. Blatt, had the primary and unconditional obligation to purchase Mrs. Blatt's shares.

Blatt v. Commissioner was appealable to the Sixth Circuit Court of Appeals.⁶⁷ With no applicable precedent in that circuit, the Tax Court was free to fashion its own rule.⁶⁸ The court refused to follow *Arnes v. United States*, enforcing instead the transaction's form, which consisted of a transfer by Mrs. Blatt of her shares to the corporation in return for cash.⁶⁹

The *Blatt* court's enforcement of the transaction's form is consistent with a recent Technical Advice Memorandum (TAM).⁷⁰ The TAM addressed a husband's transfer, pursuant to a divorce decree, of shares of a family-owned corporation to his ex-wife. Thereafter, also pursuant to the divorce decree, the corporation redeemed her shares for cash. The TAM correctly held that under section 1041, the transaction is treated according to its form: a transfer of shares from the husband to the wife, followed by a redemption by the wife. The TAM states that section 1041 allows the spouses to choose who will bear the tax consequences of the transaction. Unfortunately, the TAM relied on Q&A 9 of the regulation for that proposition. However, Q&A 9 has no applicability to the facts recited.

61. Cf. *Arnes v. Commissioner*, 102 T.C. at 536 n.4 (Beghe, J., concurring) (noting that a separation or divorce decree requiring a corporation to redeem the stock of one shareholder does not impose a primary obligation on the other shareholder to buy the stock).

62. 102 T.C. 77 (1994).

63. 981 F.2d 456 (9th Cir. 1992).

64. *Blatt*, 102 T.C. at 83.

65. *Id.* at 81. The Internal Revenue Service argued this in *Arnes v. United States*, but the Court of Appeals for the Ninth Circuit apparently rejected the argument. See Monaghan, *supra* note 41, at 942 & n.127 (citing Brief for the Appellant).

66. *Blatt*, 102 T.C. at 81-82.

67. See *id.* at 78 (noting that Gloria Blatt resided in East Lansing, Michigan, when she filed her petition). See also I.R.C. § 7482(b)(1)(A) (1988).

68. *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

69. *Blatt*, 102 T.C. at 77.

70. Tech. Adv. Mem. 9046004 (Nov. 16, 1994).

The unfortunate confusion started in *Arnes v. United States*, but it did not end there. Perhaps because that case was decided in favor of Mrs. Arnes, the Internal Revenue Service (IRS) pursued Mr. Arnes on the theory that he had received a constructive dividend when the corporation redeemed Mrs. Arnes' shares.⁷¹ Mr. Arnes' liability was decided in *Arnes v. Commissioner*,⁷² a case also appealable to the Ninth Circuit.⁷³ The Tax Court was in a difficult position because *Arnes v. United States* had provided Mrs. Arnes with a windfall: Contrary to the parties' original expectations, she was not taxed on the \$450,000 she received upon redemption of her shares.⁷⁴ In addition, the Ninth Circuit seemed to decide that, although he was not before the court, Mr. Arnes should bear the tax burden of the transaction.⁷⁵

In the Tax Court case, the majority found the legal issue in *Arnes v. Commissioner* different from that in *Arnes v. United States*.⁷⁶ If the court had not distinguished the cases, *Golsen v. Commissioner*⁷⁷ would have required the court to follow *Arnes v. United States* in *Arnes v. Commissioner* because *Arnes v. United States* was a decision of the Ninth Circuit Court of Appeals. Several judges dissented on this issue.⁷⁸ The majority held instead that Mr. Arnes, who had merely guaranteed the corporation's payment to his ex-wife, did not have a primary and unconditional obligation to buy the stock and therefore was not taxable on the transaction.⁷⁹

The Tax Court appeared to believe it was considering the constructive dividend issue only and that the Ninth Circuit had not addressed the issue in *Arnes v. United States*. The Tax Court relied on *Edler v. Commissioner*,⁸⁰ where the Ninth Circuit held that a taxpayer did not receive a constructive dividend when the corporation of which he was a majority shareholder redeemed the shares owned by his former spouse.⁸¹ *Edler* was decided before section 1041's enactment and was not cited in *Arnes v. United States*.

71. The IRS asserted a protective income tax deficiency against Mr. Arnes. *Arnes v. United States*, 981 F.2d at 457.

72. 102 T.C. 522 (1994).

73. *Id.* at 523 (noting that John Arnes resided in the State of Washington at the time he filed his petition).

74. See Monaghan, *supra* note 41, at 941 n.121.

75. *Arnes v. United States*, 981 F.2d at 458-59 (stating that "the regulation seems to provide for shifting the tax burden from one spouse to the other The transfer of \$450,000 from the corporate Treasury need not escape taxation").

76. *Arnes v. Commissioner*, 102 T.C. at 529.

77. 54 T.C. 742, 757 (1970) (requiring the Tax Court to apply a Court of Appeals decision that is squarely on point where appeal lies only to that court), *aff'd*, 445 F.2d 985 (10th Cir. 1971).

78. *Arnes v. Commissioner*, 102 T.C. at 543 (Ruwe, J., dissenting) (Parker, Swift, Gerber and Halpern, J.J., joining in Ruwe's dissent).

79. *Id.* at 530.

80. 727 F.2d 857 (9th Cir. 1984).

81. *Id.* at 859. However, the *Edler* court reached this conclusion because a nunc pro tunc order had been entered. *Id.* The court noted that had no such order been entered the transfer may have been considered a constructive dividend. *Id.*

Unfortunately, the Tax Court failed to realize that although *Arnes v. United States* may have been wrong, it did decide the legal issues dispositive in *Arnes v. Commissioner*. That is, *Arnes v. United States* interpreted the regulation to cover Mrs. Arnes' transfer to the corporation.⁸² The regulation provides that she is deemed to transfer her shares to Mr. Arnes, who is deemed to transfer them to the corporation, and the court so held.⁸³ The court further found that "[t]he \$450,000 was paid to [Mrs. Arnes] by [the corporation] on behalf of [Mr. Arnes]."⁸⁴ Thus, the Ninth Circuit interpreted the regulation to permit a deemed transfer of cash from Mr. Arnes to Mrs. Arnes. As part of the deemed transaction, Mrs. Arnes was deemed to transfer her shares to Mr. Arnes, and Mr. Arnes was deemed to transfer cash to her. In effect, the Ninth Circuit deemed Mr. Arnes to have purchased his wife's shares, and this action fulfilled his unconditional purchase obligation.⁸⁵ The Tax Court's holding that Mr. Arnes did not have a constructive dividend⁸⁶ is consistent with *Arnes v. United States*. However, the Tax Court should have employed the logic of the regulation, as interpreted in *Arnes v. United States*, since *Golsen* requires it to do so.

Although applying *Golsen* to *Arnes v. United States* leads to the conclusion that Mr. Arnes did not receive a constructive dividend, *Golsen* would nevertheless require Mr. Arnes to be taxed.⁸⁷ That is, although the IRS apparently did not address the issue, the Tax Court should have considered section 1041's application to Mr. Arnes. The Ninth Circuit held that the regulation, with all its consequences, applied to the transaction. In light of the Ninth Circuit's holding that the regulation applied to the transaction, the regulation provides a precedent for both redeeming and nonredeeming spouses. In particular, under *Golsen*, the Tax Court should have applied the Ninth Circuit's holding to require that Mr. Arnes pay tax on the corporation's redemption of the shares he was deemed to have received from Mrs. Arnes. In fact, the Ninth Circuit implied that Mr. Arnes, not his wife, would bear the tax.⁸⁸ Although this may have been unwise, since Mr. Arnes was not before the court, the Ninth Circuit's holding virtually requires both Mr. Arnes and other nonredeeming spouses to pay the tax in subsequent Ninth Circuit cases. This is unfortunate since, as discussed above, it results in greater aggregate taxation for the couple than if the spouse who had actually redeemed her shares was taxed.

Because *Arnes v. Commissioner* did not apply the holding of *Arnes v. United States*, both Mr. and Mrs. Arnes escaped paying tax on the redemption of her shares, despite the bail-out of \$450,000 cash from the corporation.⁸⁹ As

82. *Arnes v. United States*, 981 F.2d at 460.

83. *Id.* at 459.

84. *Id.*

85. *Id.*

86. *Id.*

87. See *Golsen v. Commissioner*, 445 F.2d 985, 989 (10th Cir. 1971).

88. See *Arnes v. United States*, 981 F.2d 456, 458-59 (9th Cir. 1992).

89. See *Arnes v. Commissioner*, 102 T.C. 522, 534 (1994) (Beghe, J., concurring). In a recent private letter ruling, the IRS followed *Blatt* and *Arnes v. Commissioner* and distinguished *Arnes v. United States*. See Priv. Ltr. Rul. 9427009 (July 8, 1994).

discussed above, the one certainty is that at least one of the Arnesees should pay a tax.⁹⁰ A concurring opinion stressed the need for the IRS, as a stakeholder, to facilitate consolidation of the cases.⁹¹ Consolidation would help prevent the government from being whipsawed. Presumably, once one court categorized the transaction in a certain way, it would apply consistently to both parties.

*Hayes v. Commissioner*⁹² presented an issue similar to that decided in *Arnes v. Commissioner*. In *Hayes*, as in the *Arnes* cases, Mr. and Mrs. Hayes co-owned a corporate McDonald's franchise.⁹³ Under the spouses' separation agreement, Mr. Hayes agreed to purchase Mrs. Hayes' stock in the corporation.⁹⁴ The court entered judgment in the divorce proceeding, incorporating the provision of the separation agreement obligating Mr. Hayes to buy Mrs. Hayes' stock.⁹⁵ On the same day, the corporation agreed to redeem Mrs. Hayes' stock.⁹⁶ Approximately one year later, the court entered a *nunc pro tunc* order purporting to modify the original divorce judgment to provide that the corporation would redeem Mrs. Hayes' stock.⁹⁷ The Tax Court held that Mr. Hayes had a primary and unconditional obligation to purchase the stock, and that the purchase by the corporation resulted in a constructive dividend to Mr. Hayes.⁹⁸ The court found the *nunc pro tunc* order invalid under Ohio law. Furthermore, even if it was valid, the entry of judgment in the divorce proceeding would have extinguished Mr. Hayes' preexisting primary and unconditional obligation under the separation agreement, substituting the corporation's obligation.⁹⁹ Thus, the court held that Mr. Hayes received a constructive dividend under general tax principles.¹⁰⁰

In *Hayes*, because the IRS had asserted deficiencies against both Mr. and Mrs. Hayes and the proceedings were consolidated, the IRS acted as a stakeholder and conceded that if Mr. Hayes was taxable, Mrs. Hayes was protected by section 1041.¹⁰¹ Given this concession, the court did not need to consider whether section 1041 insulated Mrs. Hayes from taxation on the redemption. However,

90. See *Arnes v. Commissioner*, 102 T.C. at 533-34 (Beghe, J., concurring). See also *Arnes v. United States*, 981 F.2d at 458-59.

If neither John nor Joann is taxed, the \$450,000 used to redeem Joann's appreciated stock apparently will be taken out of the corporation tax-free. . . . The transfer of \$450,000 from the corporate treasury need not escape taxation, if we hold, as we do, that Joann is not required to recognize any gain on the transfer of her stock

Id.

91. See *Arnes v. Commissioner*, 102 T.C. at 531-532 (Beghe, J., concurring).

92. 101 T.C. 593 (1993).

93. *Id.* at 595.

94. *Id.*

95. *Id.* at 596.

96. *Id.*

97. *Id.* at 596-597.

98. *Id.* at 605.

99. *Id.*

100. *Id.* at 605.

101. *Id.* at 606.

the court unfortunately stated: "If we were to accept respondent's argument, Mrs. Hayes would be shielded by section 1041 from recognizing gain on the redemption."¹⁰² This statement implies that the court believes a holding of "primary and unconditional obligation" automatically shields Mrs. Hayes from taxation.

In cases like *Hayes*, the IRS is not really a stakeholder because both spouses could owe a tax under present law.¹⁰³ It would seem to be in the IRS's interest to argue that the regulation does not apply to redemptions and pursue both the husband (on a constructive dividend theory) and the wife (for the redemption). However, consolidation of these types of cases at least helps prevent the whipsaw to the government that occurred in the *Arnes* cases. Consolidation also helps to insure that at least one tax is paid. Equally important, it eliminates a problem evident in the *Arnes* cases: the discovery of facts in the wife's case that were unfavorable to the husband, who was not before the court.¹⁰⁴

IV. THE TEMPORARY REGULATION: CONCLUDING THOUGHTS

As discussed at length, the regulation is technically inapplicable in the redemption context, although it can serve as a tool to reach the theoretically correct result in some scenarios. The worst possible situation is uncertainty.¹⁰⁵ Either Congress, the Treasury Department or the court must provide clarification. The best approach would be not to apply the regulation in the redemption context. In that case, section 1041 would not apply to Situation Three, where the husband did not have a primary and unconditional obligation to purchase the wife's shares. She would pay a tax on the redemption, and he would not. In Situation Four, where the husband agreed unconditionally to buy the wife's shares, and he shifted the obligation to the corporation, the law should be clarified, probably by regulation,¹⁰⁶ to avoid an unnecessary extra tax. The wife would be deemed to have transferred her shares to the husband in return for cash, thus satisfying his obligation. The cash would be deemed to come from the corporation in return for the husband's deemed transfer of the shares to the corporation. This would result in no tax to the wife, consistent with the transaction the parties had agreed on (which was a straightforward 1041 transaction), and probably would result in

102. *Hayes v. Commissioner*, 101 T.C. 593, 597 (1993).

103. See *Schroeder v. Commissioner*, 831 F.2d 856, 859 (9th Cir. 1987); *Wall v. United States*, 164 F.2d 462, 465 (4th Cir. 1947). See also Rev. Rul. 69-608, 1969-2 C.B. 48.

104. See *Arnes v. Commissioner*, 102 T.C. 522, 530; *id.* at 536-537 (Beghe, J., concurring).

105. Uncertainty results in opportunities for game-playing, possible whipsawing, and the possibility of saddling one spouse with a much greater tax burden than was negotiated. See *id.* at 540, 541 n.8 (noting that commentators had already spotted opportunities for game playing, and commenting that if Mr. Arnes was taxed instead of Mrs. Arnes "she would receive and retain more than twice as much of the community property as [Mr. Arnes]").

106. Unlike Question & Answer 9 of the regulation, the regulatory action suggested would be specific to the redemption context. See Temp. Treas. Reg. § 1.1041-1T (1992). It could take the form of an additional question and answer in the regulation or an additional regulation.

dividend treatment to the husband, consistent with the result he would get even if she were taxed, as a result of his "blunder."

Assuming the courts continue to apply the regulation in the redemption context, they should nevertheless limit its use to situations where it produces defensible results. Certainly it should not be applied to Situation Three, where it results in more aggregate tax and reaches a result contrary to the spouses' agreement. The regulation produces better results in Situation Four. The wife would not be taxed, as agreed, and the husband would be taxed, presumably receiving dividend treatment.

If, as applying the regulation to Situation Four and not Situation Three suggests, the regulation only applies when the nonredeeming spouse had a primary and unconditional obligation to purchase the other spouse's shares—an obligation that he shifted to the corporation—effectively this would mean "on behalf of" would be defined coextensively with "primary and unconditional obligation."¹⁰⁷ In *Arnes v. Commissioner*, the majority expressly noted that it did not consider whether the phrase "on behalf of" in the regulation is the same as a "primary and unconditional obligation."¹⁰⁸ However, Judge Beghe argues that the best course is to interpret section 1041 and the regulation so that no redemption of one spouse will "be considered to be 'on behalf of' the remaining spouse unless it discharges the spouse's primary and unconditional obligation to purchase the subject stock."¹⁰⁹ If the regulation is stretched to fit the redemption context, then Judge Beghe's approach is probably best.

Whether the regulation is stretched to fit the redemption context or the Treasury Department promulgates a new regulation more suited to redemptions, applying section 1041 to Situation Four and not to Situation Three, and otherwise enforcing the form of the spouses' transaction, leaves them with the option of deciding who will pay the tax. This is essential for section 1041 to perform its divorce-related function correctly.

107. See *Arnes v. Commissioner*, 102 T.C. at 530.

108. *Id.*

109. *Blatt v. Commissioner*, 102 T.C. 77, 85 (1994) (Beghe, J., concurring).